

## IRS/DOR Tax Update

### TCJA Impact on Businesses Including the Qualified Business Income Deduction – Section 199A

*Presented by:*

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## Section 199A: Qualified Business Income (QBI) Deduction

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## Treasury/ IRS Issue Proposed Regs

- Proposed Regs on Section 199A issued on August 8, 2018 (184 pages)
- Also, Notice 2018-64 issued to provide methods for calculating Form W-2 wages for purposes of the limitations on deduction

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## Qualified Business Income Deduction: Section 199A

### Overview

- Applies to non-corporate taxpayers-
  - Individuals ( including children subject to the Kiddie tax)
  - Estates
  - Non-granter trusts
- Applies to tax years beginning 2018 → 2025
- Applies to income from an S Corp., Schedule E real estate rentals, partnerships or sole proprietors
- Applies only to QBI effectively connected with conduct of a trade or business within the U.S.
- QBI includes items of income, gain, deduction and loss
- No distinction between passive and active income
- Effectively reduces top rate of 37% to 29.6%

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## QBI Does not include

### Overview

- Certain investment income, including short-term and long-term capital gains
- Reasonable Compensation paid to the taxpayer
- Guaranteed payments paid to the taxpayer

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## Section 199A ( QBI deduction) Does Not apply to

- Computation of Net Investment Income Tax (NIIT)
  - Computation of SSA benefits
  - Computation of S. E. Tax
- The Big Question – currently the QBI deduction computation does not consider certain “adjustment to income”, such as the SEP deduction, 50% of S.E. tax deduction and the deduction for S.E. health insurance. Will Congress change this?

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### Quick Reference Chart - The QBI Deduction

#### MFJ :

(Net) Taxable Income	Specified Services	Other Businesses
<\$315,000	QBI x 20%	QBI x 20%
\$315,000-\$415,000	Phase-out of Deduction ( W-2/ Asset Limitations Apply)	Phase-in of W-2/Asset Limitation Rule
>\$415,000	No Deduction	Full W-2/Asset Limitation Rule APPLIES

#### Other than MFJ (Including Trusts and Estates) :

(Net) Taxable Income	Specified Services	Other Businesses
<\$157,500	QBI x 20%	QBI x 20%
\$157,500-\$207,500	Phase-out of Deduction ( W-2/ Asset Limitations Apply)	Phase-in of W-2/Asset Limitation Rule
>\$207,500	No Deduction	Full W-2/Asset Limitation Rule APPLIES

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### QBI – Wage/Asset Limitation

- Wage Limitation does not apply if taxable income does not exceed \$315,000
  - Limitation phases in when taxpayer's taxable income exceeds \$315,000 for MFJ (\$157,500 for others).
  - Phase-in is over the next \$100,000 of taxable income for MFJ (\$50,000 for others).
- If taxable income > \$415,000 - MFJ (\$207,500 for others) - the deduction cannot exceed the greater of:
  - 50% of (allocated share of) W-2 wages of the trade or business, or
  - 25% of (allocated share of) W-2 wages of the trade or business, **PLUS** 2.5% of the unadjusted basis of all qualified property held by and available for use in the T/B at the close of the year

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### W-2 Wages

- Paid with respect to employment during the calendar year
- Limited to wages paid attributable to QBI
- Wages do not include any amount which is not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date for such return (including extensions)

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### Qualified Property

- With respect to a qualified trade or business
- Tangible property (personal or real), subject to the allowance for depreciation under Section 167
  - Held for use in a qualified t/b at the close of the taxable year,
  - Used at any point during the taxable year in the production of qualified business income, and
  - the depreciation period has not ended before the close of the taxable year.

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### Qualified Property Continued

- Depreciable period-
  - Beginning on the date placed in service by the taxpayer
  - Ending on the later of
    - Date which is 10 years after such date, or
    - the last day of full year in the applicable recovery period that would apply to the property under Section 168

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### QBI Deduction for Specified Service Industry

- Generally does not apply
- Exception if taxable income of individual does not exceed \$315,000 (MFJ), \$157,500 (for others).
- Exception is phased-out over the next \$100,000 (MFJ), \$50,000 (for others)
- QBI deduction does not apply to the business of performing services as an employee.
- Specified services include any trade or business involving the performance of services in the field of health, law, accounting, actuarial sciences, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interest, or commodities (but not engineers and architects).

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### QBI Examples: Example #1

- Basic Rule: Combined QBI deduction cannot exceed taxable income (net of capital gains) x 20%
- John is a married accountant with business income of \$150,000
  - QBI Deduction:  $\$150,000 \times .20 = \$30,000$
  - Net Taxable Income: \$200,000
  - $\$200,000 \times .20 = \$40,000$
  - QBI deduction is not limited
- Mary is a married accountant with business income of \$250,000
  - QBI Deduction:  $\$250,000 \times .20 = \$50,000$
  - Net Taxable Income: \$200,000
  - $\$200,000 \times .20 = \$40,000$
  - QBI deduction is limited to \$40,000

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### QBI Examples: Example #2

#### For Non-Specified Service Businesses:

- When taxable income exceeds \$415,000 (MFJ), the QBI deduction is limited to the greater of:
  - 50% of Wages or
  - 25% of Wages **PLUS** 2.5% of unadjusted basis of property
- Bruce is married and has a yard cleaning company and has taxable income of \$600,000 and the QBI amount from the company is \$100,000. The company pays wages of \$50,000 and has nominal assets
- Lesser of:
  - $\$100,000 \times .20 = \$20,000$
  - Limited to:  $\$50,000 \text{ (wages)} \times .50\% = \$25,000$
  - Bruce's QBI deduction is not limited

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### QBI Examples: Example #3

- Bruce also owns a commercial rental property that generates \$8,000 of QBI. Assume the property is fully depreciated and there are no employees.
- The QBI deduction is \$0

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#### QBI Examples: Example #4

- Same as EXAMPLE #3 except the building is not fully depreciated and was purchased for \$250,000, which includes land cost of \$50,000.
  - QBI deduction is  $\$8,000 \times .20 = \$1,600$
  - $(\$0 \text{ wages} \times .25) \text{ PLUS } \$200,000 \text{ (net of land)} \times .025 = \$5,000$
  - QBI deduction of \$1,600 is not limited

#### QBI Examples: Example #5

- Jordon is married and has a widget producing business that generates \$100,000 of QBI. His taxable income is over \$415,000. In addition, he paid wages of \$30,000 and has qualified property of \$50,000.
  - $\$100,000 \times .20 = \$20,000$
  - Wage Test 1:  $\$30,000 \times .50 = \$15,000$
  - Wage Test 2:  $(\$30,000 \times .25) + (\$50,000 \times .025) = \$8,750$
  - QBI deduction is limited to \$15,000 (the greater of \$15,000 or \$8,750)

#### Section 199A Application to trusts, estates and beneficiaries

- A trust or estate is treated as a passthrough entity to the extent it allocates QBI and other items to its beneficiaries and is treated as an individual to the extent it retains the QBI and other items.

### Section 199A – Grantor Trusts

- To the extent the grantor or another person is treated as owning all or part of a trust under sections 671 through 679, such person computes its section 199A deduction as if that person directly conducted the activities of the trust with respect to the portion of the trust treated as owned by that person.

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### Section 199A – Non - Grantor Trusts and Estates

- Trust or estate must allocate qualified items of deduction in computing QBI.
- Depletion, amortization and depreciation that are otherwise properly included in the computation of QBI are included in such computation, regardless of how they may otherwise be allocated between the trust or estate and its beneficiaries
- QBI is to be allocated to each beneficiary and to the trust or estate based on relative proportion of DNI for the taxable year, or is to be retained by the trust or estate.
- If no DNI for the taxable year, all items are allocated to the trust or estate.

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### ESBTs

- S portion
- Grantor portion
- Non-S portion

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### Threshold and Anti-Abuse Rule

- \$157,500 → \$207,500 in 2018
- Increased by COLA 2019 → 2025
- Taxable income of estate/trust is determined before taking into account any distribution deduction under section 651 or 661
- Trusts formed or funded with significant purpose of receiving a deduction under Section 199A will not be respected.
- Two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor(s), beneficiaries and if the principal purpose\* for establishing such trusts or for contributing additional cash or other property, is the avoidance of Federal income tax. Spouses will be treated as one person. Reg. Section 1.643 (f)-1.

\*significant non-tax purpose

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### Planning For Trusts

- If holding fully depreciated real property that has no basis, consider transferring business interest to a CRT
- Making a Section 645 election may hurt the estate/trust's QBI deduction

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## Business Provisions

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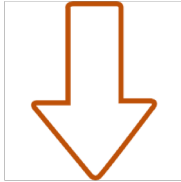
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### Corporate Tax Rates Reduced (after 2017)

- Prior rates: 15%, 25%, 34%, and 35% (Personal Service Corps. paid at the 35% rate)
- For tax years beginning in 2018: Flat 21% (including Personal Service Corps.)



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### Dividends-Received Deduction Reduced (after 2017)

	2017	After 2017
If corporation owns at least 20%	80%	65%
Less than 20%	70%	50%

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### Corporate Alternative Minimum Tax

- Repealed for tax years beginning after 2017
- 2018 - 2020: AMT credit is refundable and can offset the regular tax liability equal to 50% of the excess of the minimum tax credit for the year over the credit against the regular tax liability
- 2021 - 2022: 100% of excess



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### Net Operating Loss Deduction (after 2017)

For NOLs arising after 2017

- 2-year carryback and special carryback provisions repealed
- 2-year carryback still available for farming trade/business
- NOL deduction is limited to 80% of taxable income
- NOL can be carried forward indefinitely
  - Except for property and casualty insurance companies - 2 years back and 20 years forward with 100% offset

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### Limit on Deduction for Business Interest

- For tax years beginning after 2017
- Applies to all forms of business (see exceptions)
- Net interest expense is limited to 30% of the business's adjusted taxable income
- Determined at the tax filer's level, except for pass-through entities, where the determination is made at the entity level.
- "Adjusted taxable income"- 2018 through 2021 - computed without regard to deductions for depreciation, amortization, or depletion.
- Disallowed interest deduction is carried forward as business interest paid in the succeeding year and can be carried forward indefinitely (certain restrictions for partnerships)

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### Exemption and Exclusions From New Interest Limitation Rules

- Business that meet the \$25 million gross receipts test (other than tax shelters) are exempt from the new interest limitation rules (prior 3-year average)
- Real property trade/business can elect out if they use ADS to depreciate applicable property
- Floor plan financing is exempt from the limitation rules



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### Interest Limitation Rules Applicable to Partnerships

- Limitation is first determined at entity level and taken into account and allocated as part of non-separately stated taxable income or loss.
- Any excess interest expense is allocated to partners and reduces partner's basis in partnership. Can be carried forward to future years.
- To the extent partnership has "excess capacity" (interest income + 30% of business income in excess of interest expense), "excess capacity amount" is allocated to partners who can use as basis to deduct any carried forward excess interest expense (no further basis reduction).
- Upon disposition of partnership interest, basis is increased to the extent of unused excess interest expense previously allocated to the partner and previously reduced his/her basis.

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### Domestic Production Activity Deduction (after 2017)

Repealed for tax years beginning after 2017



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### Like-kind Exchanges (transfers after 2017)

- For transfers made after 2017, Section 1031 will only apply to real property that is not held primarily for sale (will no longer apply to tangible personal property).
- Transition rule for pre-Act TPP if taxpayer has either disposed of the relinquished property or acquired the replacement property on or before 12/31/2017

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### Employee Achievement Awards (after 2017)

Clarification that tangible personal property given to an employee in recognition of either length of service or safety achievement does not include cash, cash-equivalent, gift cards, gift coupons, gift certificates, vacations, meals, lodging, tickets for theater or sporting events, stocks, bonds, or similar other non-tangible property.



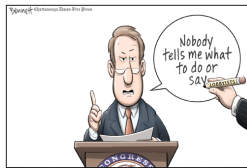
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### Deduction for Local Lobbying Expenses

After date of enactment (12/22/2017), deduction for lobbying expenses with respect to legislation before local government bodies is eliminated



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### Exclusions From Contribution to Capital

Effective for contributions made after the date of enactment (12/22/2017), subject to a pre-approved exception

- "Contribution" capital does not include:
  - any contribution in aid of construction or any other contribution as a customer or potential customer, or
  - any contribution by a government entity or civic group, other than as a shareholder
- The nonrecognition of income rules under Section 118 would not apply to the above contributions to the corporation

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## Repeal of Rollover of Publicly Traded Securities Gain Into Specialized SBICs

Tax-free rollover provision of Section 1044 is repealed for sales after 2017

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## Section 179 Expensing

- For property placed in service in tax years beginning after 2017
- \$500,000 maximum annual amount increases to \$1 million
- \$2 million phase-out amount increases to \$2.5 million
- The definition of Section 179 property is expanded to include certain depreciable TPP used predominantly to furnish lodging or in connection with furnishing lodging
- Also included - improvements to nonresidential real property after the date the property was first placed in service:
  - Roofs
  - HVAC property
  - Fire protection and alarm systems
  - Security systems



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## Temporary 100% Bonus Depreciation

- For qualified property acquired and placed in service after September 27, 2017 and before January 1, 2023
- Increased bonus depreciation amount goes from 50% to 100% of adjusted basis of property
- Allowed for new OR used property
- Prior phase-down rules repealed, replaced by:
  - 80% for property placed in service in 2023
  - 60% for property placed in service in 2024
  - 40% for property placed in service in 2025
  - 20% for property placed in service in 2026
- Sunsets after 2026
- For first tax year ending after 9/27/2017, taxpayer can elect to claim 50% bonus first-year depreciation instead of 100%

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### Luxury Auto Depreciation Limit

- For vehicles placed in service after 2017 in tax years ending after 2017
- If bonus depreciation is not claimed:

	2017	After 2017
1 <sup>st</sup> year	\$3,160	\$10,000
2 <sup>nd</sup> year	\$5,100	\$16,000
3 <sup>rd</sup> year	\$3,050	\$9,600
4 <sup>th</sup> year and after	\$1,875	\$5,760

- Indexed for inflation after 2018
- Additional bonus depreciation allowance remains at \$8,000 (presumed without phase down as under Pre-Act rules). Auto purchases prior to 9/27/17 and in service after that date are subject to Pre-Act phasedown limits.

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### Shortened Recovery Period for Real Property (After 2017)

- Separate definitions of qualified leasehold improvements, qualified restaurant and qualified retail improvements is eliminated
- Now, improvements (interior) for non-residential property
  - 15 years (20 years ADS)
  - S.L.
  - ½ yr. convention\*
  - 3 year rule also eliminated
  - Property no longer has to be subject to a lease

**\*Except for restaurant improvements that are not qualified improvement property, which must use mid-month convention.**

- After 2017, ADS recovery period for residential rental property is shortened from 40 to 30 years.
- Special rules for electing farming businesses

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### Employer Deduction for Fringe Benefits Paid (Incurred or Paid After 2017)

- Deduction for entertainment is disallowed.
  - Thus, the cost of Eagles tickets is not deductible, but 50% of the beer is.
- 50% meals deduction is expanded to include meals provided through in-house cafeteria or otherwise on the employer's premise.
- After 2025 the deduction for employer provided meals for the convenience of the employer is disallowed.
- Deduction for employee transportation fringe benefit is disallowed (i.e. parking and mass transit), but the benefit to the employee is still tax-free.
- No deduction allowed for transportation expense paid for employee commuting, except for safety reasons.



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### Write-off of R&E Expenses

- Paid or incurred in tax years beginning after 2021
- Old law - (1) expense, (2) capitalize + recover over less than 60 months, or (3) recover over 10 years.
- New law - capitalize and amortize over 5 years (15 years if conducted outside of the U.S.), beginning with the mid-point of the year in which the expense was paid or incurred.

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### Partnership Technical Terminations

- Repealed for partnership tax years beginning after 2017.
- Avoids loss of tax attributes, partnership elections, close of partnership tax year and restart of depreciation recovery periods.



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### Sale of Partnership Interest

#### For sales, exchanges and dispositions after 2017

- The transferee must withhold 10% of the amount realized on the sale or exchange of the partnership interest unless the transferor certifies they are not a nonresident alien individual or corporation (Section 1446 (f)).
- The definition of a substantial built in loss is modified (for basis adjustment purposes) to include that a substantial built in loss would also exist if the transferee would be allocated a net loss in excess of \$250,000 upon a hypothetical disposition by the partnership of all of the partnership's asset's in a fully taxable transition for cash, equal to the asset's FMV, immediately after the transfer of the partnership interest. (Section 743 (b)).

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### Treatment of S Corporation Converted to C Corp

- Limited applicability-only to “eligible terminated S Corps”-
  - was an S Corp the day prior to enactment (12/22/17),
  - revokes S election during 2-yr. period beginning on date of enactment, and
  - same shareholders before and after revocation.
- Any Section 481 (a) adjustment of an “eligible terminated S corp.” attributable to its S revocation (i.e., change from cash to accrual method), is taken into account ratably over a 6-year period, beginning with the year of change.

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### Accounting Changes - Cash Method of Accounting

- Generally for C Corps and partnerships with C Corp as partner
- For tax years beginning after 2017
- Cash method of accounting can be used by all taxpayers (except tax shelters) that -
  - Satisfy the \$25 million gross receipts test (indexed for inflation)
  - Regardless of whether the purchase, production or sale of merchandise is an income producing factor
  - Gross receipts test = annual average gross receipt over 3 prior years < \$25 million
  - Use of this provision results in a change of accounting method (Section 481).
- Exceptions for qualified personal service corporations and taxpayers other than C Corporations is retained

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### Accounting for Inventory

- Pre-Act: Certain small businesses that meet a gross receipts test with average gross receipts of not more than \$1 million (\$10 million for some industries), can use the cash method of accounting and account for inventories as non-incidental materials and supplies.
- TCJA: For tax years beginning after 2017, taxpayers that meet the \$25 million gross receipts test can account for inventories as
  - Non-incidental materials and supplies or
  - Method that conforms to the taxpayer's financial statement treatment of inventories
  - Use of provision results in a change of accounting method-Section 481



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### Inventory Capitalization - Section 263A

- For tax years beginning after 2017
  - Producers or resellers that meet the \$25 million gross receipts test are exempt from the UNICAP rules
  - Exemption does not apply if not based on gross receipts
  - Use of provision results in a change of accounting method-Section 481

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### Accounting for Long-Term Contracts

- For contracts entered into after 2017 in tax years ending after 2017
- Exception from use of LTC method is expanded to include:
  - Contracts expected to be completed within two years of commencement of contract AND
  - Taxpayer performing work is expected to meet the \$25 million gross receipts test for the tax year in which the contract is entered into
- The above is in addition to the Pre-Act exception if Average 3-year gross receipts do not exceed \$10 million



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## Questions

Valerie Middlebrooks, CPA - December 10, 2018  
Karly Laughlin, CPA - December 10, 2018  
Jordon Rosen, CPA, MST, AEP® - December 11 and 13, 2018

*BLS*  
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